

Summary of Third Interested Parties Meeting
Regulation § 25106.5-1
Intercompany Transaction Regulation

- I. Administration: On August 16, 2011 at 1:00 p.m., members of the public attended an interested parties meeting at the Franchise Tax Board's Sacramento central office. Parties attended in person and by telephone. Those physically present were asked to register at the entrance and those on the telephone were asked to fax a business card to Colleen Berwick for later correspondence. Phone participants introduced themselves. The session was tape recorded for reference but there would be no attribution of comments and no transcript. The Hearing Officer was Craig Swieso. Available handouts were: notice of the meeting, discussion topics, and proposed language. Parties were told that a summary of the interested parties meeting would be posted online.

The purpose of the meeting was to allow the public to discuss the proposed amendments to the Deferred Intercompany Stock Account (DISA) provisions of California Code of Regulations, title 18, (CCR) section 25106.5-1, subsection (f).

- II. Discussion: The discussion was organized topically, covering the following four areas:
- Allowing subsequent capital contributions to reduce and/or eliminate an existing DISA balance.
 - Creating earnings and profits for DISA purposes in instances involving tiered distributions to multiple combined reporting group members.
 - General prospective or retroactive application of the proposed amendments.
 - Application of recent federal consolidated return regulations revisions to DISAs.

A. Subsequent Capital Contributions

- Proposed revisions to CCR section 25106.5-1, subsection (j)(7), requires taxpayers to report changes to DISA balances due to subsequent capital contributions. However, the proposed language does not indicate the duration of this requirement. For instance, if a subsequent capital contribution eliminates a DISA in Year One, must the taxpayer continue to report the elimination in Year Ten?
- In response it was pointed out that FTB Form 3726 – "DISA and Capital Gain Information" is used to report DISA balances. FTB Form 3726 will be revised to report changes to DISAs due to subsequent capital contributions. Obviously the changes must be reported in the year that they occur. It has yet to be determined internally how many additional years, if any, the changes must be reported.

B. Creating Earnings and Profits in instances involving distributions to multiple combined reporting group members.

- Proposed revision to CCR section 25106.5-1, subsection (j)(4), provides that in instances when the same amount of money or the same property is distributed to one member, who immediately thereafter distributes it to another member, any DISA resulting from the initial distribution will be treated as earnings and profits for purposes of determining a DISA arising from the following distribution. It was asked why the second distribution must occur "immediately" following the first distribution? In many instances, an interval between distributions might occur. In such situations, the same treatment should be allowed.
- In response, it was agreed that the term "immediately" will be struck from the proposed revision to CCR section 25106.5-1, subsection (j)(4).

C. Prospective/retroactive application of proposed revisions.

- California Revenue and Taxation Code section 19503, subdivision (a), generally provides that revisions to CCR section 25106.5-1 be applied on a retroactive basis unless the Franchise Tax Board provides otherwise. It was asked if the FTB will seek to apply the revisions to the DISA provisions on a retroactive or prospective basis.
- In response, it was pointed out that the separate entity treatment provisions contained at CCR section 25106.5-1, subsection (e)(2), are also being revised. There have been comments from the public that these provisions should only be applied on a prospective basis.
- When asked if there would be any objections to the revisions to the DISA provisions not being applied on a prospective basis, none of the participants expressed any.

D. Application of recent federal consolidated regulation revision to DISAs

- In prior IPMs it was mentioned that the version of the federal consolidated return intercompany transaction regulations (i.e., Treasury Regulation section 1.1502-13), which is incorporated by CCR section 25165.-1, subsection (a)(2), will be updated. (The most recent version of Treasury Regulation section 1.1502-13 that is available online is current through April 2010.) On April 4, 2011, the Internal Revenue Service released Treasury Decision (TD) 9515 as part of Internal Revenue Bulletin 2011-14. In TD 9515 it was announced that on March 4, 2011, Treasury Regulation section 1.1502-13, subsection (c)(6)(ii)(C), was being revised to provide for the exclusion of deferred gain attributable to an intercompany sale of stock when the consolidated reporting group member whose stock was the subject of the sale is liquidated pursuant to Internal Revenue Code section 332. (California Revenue and Taxation Code section 24451 incorporates Internal Revenue Section 332.) It was suggested that the DISA regulations be revised to specifically state that a DISA balance will be eliminated if it is attributable to the stock of underlying entity that is subsequently liquidated pursuant to Internal Revenue Code section 332.
- In response it was pointed out that the new version of Treasury Regulation section 1. 1502-13, subsection (c)(6)(ii)(C), pertains to gains from the intercompany sale of stock. On the other hand, DISAs arise due to excess distributions. Allowing the suggested treatment would be expanding the rule to a fact pattern not addressed in the revised Treasury Regulation.

- It was mentioned that the federal consolidated return regulations currently allow a liquidation to eliminate any potential gain relating to an excess distribution. Therefore, the new rule merely expands the same treatment to gains resulting from sales.
- In response it was emphasized that due to certain constitutional limitations, California is unable to adhere to the existing federal consolidated return regulations that currently allow a liquidation to eliminate any potential gain relating to an excess distribution.
- It was mentioned that pursuant to California Revenue and Taxation Code section 25106.5, the Franchise Tax Board possesses the statutory authority to apply the new version of Treasury Regulation section 1.1502-13, subsection (c)(6)(ii)(C).
- In response it was stated that although California Revenue and Taxation Code Section 25106.5 might provide the blanket authority to apply the new version of Treasury Regulation section 1.1502-13, subsection (c)(6)(ii)(C), that would necessitate additional Interested Parties Meetings. The regulation project to revise the DISA provisions of CCR section 25106.5-13 commenced approximately two years ago. To date, the revisions to the DISA provisions that have been vetted by the public have yet to be formally adopted under the Administrative Procedure Act. Additional Interested Parties Meetings to further vet the application of the new version of Treasury Regulation section 1.1502-13, subsection (c)(6)(ii)(C), will only further delay the probable formal promulgation of these revisions, which will further delay the practical favorable treatment afforded by them. In essence, there needs to be finality with respect to the revisions to the DISA provisions.
- It was suggested that the regulation project proceed, but that in the future the Franchise Tax Board should consider revising the DISA provisions to apply the new version of Treasury Regulation section 1.1502-13, subsection (c)(6)(ii)(C), as suggested.

E. Subsequent Written Comments

- CCR section 25106.5-1, subsection (f)(2), Example 10, states:
Facts: P and S and T are members of a combined reporting group. P owns 100% of T's stock. P and T each own 50% of S's stock. P and T each have a separate basis in S's stock of \$500. Due to an excess distribution, P has a \$400 DISA attributable to its stock in S.

The comment is that this is confusing because if P has a DISA with respect to its stock in S, then P would not have a basis in S's stock of \$500.

- The confusion will be alleviated by revising the facts of Example to state: P and T each *initially had* a separate basis in S's stock of \$500. (Emphasis added.)
- CCR section 25106.5-1, subsection (f)(1)(B)2., should be revised to allow P's subsequent purchase of stock from S to reduce any outstanding DISAs attributable to existing stock of S owned by P.
- This revision would potentially create administrative difficulties. The taxpayer and the taxing agency would be forced to track the basis pertaining to separate stock issuances. This

difficulty would only be compounded if the purchase price of the additional stock cost didn't entirely eliminate a DISA attributable to existing stock.

- Proposed revision to CCR section 25106.5-1, subsection (j)(4), provides that in instances when the same amount of money or the same property is distributed to one member, who immediately thereafter distributes it to another member, any DISA resulting from the initial distribution will be treated as earnings and profits for purposes of determining a DISA arising from the following distribution. What is the policy reason why the second distribution must occur "immediately" following the first distribution? In many instances, an interval between distributions might occur. In such situations, the same treatment should be allowed.
- This matter was discussed at the Interested Parties Meeting and it was agreed that the term "immediately" will be struck from the proposed revision to CCR section 25106.5-1, subsection (j)(4).
- CCR section 25106.5-1, subsections (f)(1)(B) and (f)(1)(B)3., should be revised to specifically state that a DISA balance will be eliminated if it is attributable to the stock of entity that is subsequently liquidated pursuant to Internal Revenue Code section 332 as provided in Treasury Regulation section 1.1502-13, subsection (c)(6)(ii)(C).
- This matter was discussed at the Interested Parties Meeting. As addressed then, additional Interested Parties Meetings to further vet the application of the new version of Treasury Regulation section 1.1502-13, subsection (c)(6)(ii)(C), will only further delay the probable formal promulgation of the already vetted revisions to the DISA provisions of CCR section 25106.5-1. In essence, there needs to be finality with respect to the revisions to the DISA provisions. Furthermore, the application of Treasury Regulation section 1.1502-13, subsection (c)(6)(ii)(C), might create problems when applied to fact patterns involving a DISAs arising from the distribution of appreciated property in which Internal Revenue Code section 311, subsection (b), applies. (California Revenue and Taxation Code section 24451 incorporates Internal Revenue section 311, subsection (b).)